

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

AN INVESTIGATION INTO THE)	
DIVERSIFICATION OF RURAL ELECTRIC)	
COOPERATIVE CORPORATIONS INTO THE)	ADMINISTRATIVE
SATELLITE-DELIVERED TELEVISION)	CASE NO. 326
PROGRAMMING SERVICES)	

O R D E R

By Order entered December 28, 1988, the Commission initiated this investigation into the involvement of the Rural Electric Cooperative Corporations ("RECCs") in the distribution and sale of satellite-delivered television programming services ("satellite-TV"). A primary concern of this investigation was to ascertain whether the RECCs were properly accounting for diversified activities and whether reporting by the RECCs adequately disclosed those activities. Proper accounting is necessary to minimize the risk of cross-subsidization of satellite-TV by electric customers.

In the initial phase of this proceeding, the RECCs were requested to provide information regarding their diversification into satellite-TV. A review of the responses disclosed inconsistencies among the RECCs in their accounting for the transactions. Further, the RECCs' annual reports and audit reports did not adequately disclose their involvement in satellite-TV. Based on this information, the Commission issued an Order on August 17, 1989 finding a need to establish accounting and reporting guidelines to

ensure that RECC diversification into satellite-TV was properly accounted for and reported.

An informal conference was held on September 14, 1989 for the purpose of discussing accounting and reporting guidelines, using as a model the guidelines developed by the Commission for Kentucky Utilities Company in Case No. 10296.¹ All parties to this investigation were represented at the conference and participated in the discussion. The parties agreed that the Commission Staff would prepare draft guidelines addressing the accounting and reporting concerns, and that the draft guidelines would then be submitted to the parties for comment. The draft guidelines are attached to this Order as Appendix A.

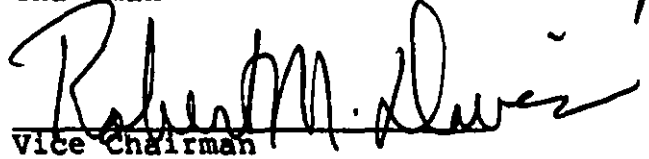
IT IS THEREFORE ORDERED that all parties of record shall file with the Commission the original and 10 copies of written comments on the draft guidelines, with a copy to all parties of record, within 30 days of the date of this Order. Parties with similar interests are encouraged to file joint comments.

¹ Case No. 10296, The Application of Kentucky Utilities Company to Enter into an Agreement and Plan of Exchange and to Carry Out Certain Transactions in Connection Therewith, Commission Order dated October 6, 1988 and final Order dated January 30, 1989.

Done at Frankfort, Kentucky, this 12th day of December, 1989.

PUBLIC SERVICE COMMISSION


Chairman


Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX A

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN ADMINISTRATIVE CASE NO. 326 DATED 12/12/89

DRAFT GUIDELINES

The following guidelines have been developed to address accounting and reporting concerns of the Commission for those Rural Electric Cooperative Corporations ("RECCs") which have become involved in the distribution and sale of satellite-delivered television programming services ("satellite-TV").

REGULATORY CONCERNS

The Commission, in this proceeding, does not challenge the involvement of the RECCs in satellite-TV diversification. However, the Commission has certain concerns and objectives with regard to the protection of the RECCs' ratepayers. One of the primary concerns is the potential which will exist for cross-subsidization of nonutility operations by the regulated RECC. Cross-subsidization can occur through misallocation of common or joint costs, or through improper accounting treatments. The process of assuring that cross-subsidization does not occur will result in added regulatory oversight by the Commission and will require increased focus on cost identification by the RECCs.

The Commission has reviewed the Uniform System of Accounts ("USoA") prescribed for electric borrowers of the Rural Electrification Administration ("REA") and agrees with the RECCs' position that no major modifications will be necessary to properly account for satellite-TV transactions. The following discussion expresses in greater detail the Commission's concerns and the conditions and

requirements necessary to ensure that the interests of the RECC ratepayers are protected. This discussion is not intended to be all inclusive.

PROTECTION OF UTILITY RESOURCES

Throughout this proceeding, two issues have been raised which impact the accounting treatments for satellite-TV transactions. First, several of the RECCs have indicated that certain satellite-TV costs incurred are minimal, and such costs should not be identified and recorded in the nonutility operation accounts, due to the immaterial nature of the cost. This position by these RECCs relates directly to the Commission's concern that the operations of nonutility activities should not be cross-subsidized by the utility ratepayers. In order to minimize the possibility that utility ratepayers cross-subsidize the satellite-TV operations, all costs must be properly identified, allocated, and recorded. The principle applies irrespective of the materiality of the cost. Nonutility operating costs should not be recorded as utility operating costs.

The second issue is the method to be utilized in accounting for the investment by the RECCs. Currently, there are two companies that have been organized to provide satellite-TV, Kentucky Telecommunications, Inc. ("KTI") and Salt River Service Corporation ("Dish Wish TV"). In order to determine the appropriate accounting treatment for the investment, the Commission has reviewed the USoA and generally accepted accounting principles ("GAAP"). The USoA defines a subsidiary as a company controlled by a utility through ownership of voting stock. Control is

further defined as the possession of the power to direct the management and policies of a company. If a subsidiary relationship exists, the controlling utility must adjust the carrying amount of the investment to recognize the utility's share of the net earnings or net losses, as well as reduce the amount of the investment by the amount of dividends received from the subsidiary. The approach outlined in the USoA is identified in GAAP as the "equity method." Under Accounting Principles Board ("APB") Opinion No. 18, the use of the equity method to account for investments is based upon the ability of the investor to exercise significant influence over the operating and financial policies of the investee, even if the investor holds less than 50 percent of the voting stock. Significant influence may be indicated in several ways, including representation on the board of directors of the investee, participation in policy making processes, material intercompany transactions, interchange of managerial personnel, or technological dependency. Determining the ability of an investor to exercise significant influence is not always clear and applying judgment is necessary to assess the status of the investment. APB Opinion No. 18 further states that, in order to achieve uniformity in application, an investment of 20 percent or more of the voting stock presumes that significant influence exists, absent evidence to the contrary. Likewise, an investment of less than 20 percent presumes that the investor does not have the ability to exercise significant influence unless such ability can be demonstrated.

The review reveals that the USoA and GAAP are in agreement concerning the accounting treatments to be used to record the RECCs' investments. The investments in KTI and Dish Wish TV establish these companies as subsidiaries of their respective RECCs. Thus, all accounting transactions should be recorded using the equity method outlined in the USoA. In the case of Dish Wish TV, which is a wholly-owned subsidiary of Salt River RECC, this determination is clear. As for KTI, the Commission is aware that all of the investing RECCs hold equal, but less than 20 percent, shares in KTI. However, as outlined in APB Opinion No. 18, the ability of the RECCs to exercise significant influence over KTI has been demonstrated. This is demonstrated by the RECCs' representation on KTI's board of directors, the involvement in policy-making decisions, and the interchange of managerial personnel. Thus, the investment in KTI should also be recorded using the equity method as described in the USoA.

Accounting Procedures and Controls

To account for the subsidiaries of RECCs, the USoA identifies a specific subaccount of Account No. 123, Investment in Associated Companies. This subaccount, Account No. 123.1, Investment of Subsidiary Companies, is where the initial investment in the subsidiary, interest accruals, loans to the subsidiary, and the amount of equity in the subsidiary's undistributed net earnings or net losses should be recorded. Because the REA has modified the USoA, and Account No. 123.1 is required to be used for a different transaction, all RECCs which have diversified into satellite-TV

should record the subsidiary transactions as Account No. 123.11, in accordance with current REA instructions.

In addition, the USoA indicates that accounts receivable and accounts payable transactions with the satellite-TV subsidiaries should be recorded in Account No. 146, Accounts Receivable from Associated Companies, and Account No. 234, Accounts Payable to Associated Companies. Interest receivable generated from loans made to the satellite-TV subsidiaries should be treated as interest accruals and recorded in Account No. 123.11. The RECCs should develop any further subaccounts necessary for Account Nos. 146 and 234 to adequately track the transactions with the satellite-TV subsidiaries.

The USoA provides three accounts to track the revenues and expenses of these subsidiaries. Revenues, with the exception of interest income, are to be recorded in Account No. 417, Revenues from Nonutility Operations; expenses are to be recorded in Account No. 417.1, Expenses of Nonutility Operations. Interest income is to be recorded in Account No. 419, Interest and Dividend Income. The RECCs should develop any further subaccounts necessary to adequately track satellite-TV subsidiary transactions.

The USoA requires that the RECCs record their share of the undistributed net earnings or net losses in Account No. 418.1, Equity in Earnings of Subsidiary Companies, with a corresponding entry in Account No. 123.11. Further, the balance in Account No. 123.11 is reduced when dividends are declared by the subsidiary. Therefore, the RECCs should record the undistributed net earnings

or net losses of the subsidiaries in Account Nos. 418.1 and 123.11.

While the accounting system in the USoA is relatively straightforward, the separation of common or joint costs through allocation methodologies is more subjective in nature and will require greater scrutiny to ensure that cross-subsidization does not occur. It is within the cost allocation procedures that one of the greatest areas of potential misclassification of utility and nonutility costs exists. The RECCs must take great care to accurately and adequately allocate all common costs between their operations and those of the subsidiaries, even those costs which appear to be immaterial. The Commission is aware that there are several acceptable methodologies available for use by the RECCs to allocate these costs. It would not be appropriate for these guidelines to designate which specific methodologies are to be used. The needs and circumstances vary among the RECCs concerning the levels of involvement in satellite-TV. The RECCs have recognized that there is a need for cost allocation and have assured the Commission that allocation procedures are in effect. It will be the responsibility of the RECCs to justify the use and appropriateness of specific methodologies in general rate case proceedings before this Commission. The RECCs should maintain adequate supporting documentation of all allocated common or joint costs.

Cross-subsidization may also occur when assets are transferred to the subsidiaries or when purchases are made from affiliated companies. While satellite-TV currently is in its developmental stage and transactions like these have not been

encountered, the RECCs should realize that such transactions are possibilities which can be reasonably anticipated. It will be the responsibility of the RECCs to ensure that all such transactions are accounted for at the appropriate price and that these transactions do not result in the cross-subsidization of the satellite-TV companies. The RECCs should maintain adequate supporting documentation for these transactions and be prepared to show during general rate case proceedings before this Commission that the transactions were reasonably priced.

Diversion of Management Talent

The Commission is aware that, under the present circumstances, some management personnel and employees of the RECCs are performing services for the satellite-TV subsidiaries. This situation has previously been addressed from an accounting standpoint. The Commission is also concerned that the utility operations of the RECCs could be neglected as a result of nonutility activities. The Commission will monitor the RECCs to ensure that utility operations do not suffer from involvement in satellite-TV or other nonutility activities.

Financial Resources

The Commission is aware that the RECCs have made loans to the satellite-TV subsidiaries. The Commission is concerned that the financial resources of the RECCs could be diminished in the assistance of the satellite-TV subsidiaries. It would not be appropriate for the RECCs to reduce services or delay necessary maintenance and construction because financial resources had been loaned to the subsidiaries. REA limits the amount of investment and

loans made to the satellite-TV subsidiaries to 15 percent of the total utility plant of the RECC. Currently, satellite-TV in Kentucky is in its developmental stage, requiring minimal investment and involvement by the RECC subsidiaries. Thus, there have been no indications that the loans made to the subsidiaries have impaired the financial resources of the RECCs. However, the Commission will maintain an ongoing review of the financial condition of the RECCs in order to minimize such a risk.

The Commission is also concerned about the impact the RECCs' involvement in satellite-TV subsidiaries will have on future capital credit assignment and rotation. It is not clear at this time what impact profits or losses from the nonutility subsidiaries will have upon the capital credit assignments. The Commission has reviewed the bylaws of the RECCs during this investigation and notes that several RECCs' bylaws contain restrictions concerning the assignment of capital credits. This situation reinforces the need for the RECCs to utilize adequate and appropriate accounting and allocation methods to minimize the risk of the nonutility activity benefiting at the expense of the RECCs' ratepayers.

ACCESS TO SUBSIDIARY BOOKS AND RECORDS

In the establishment of necessary regulatory safeguards for utility diversification, the Commission is convinced that open access to all books, records, and personnel of the subsidiaries is an important and indispensable requirement. It is essential that the Commission have the ability to monitor and review the operations of the RECC through access to the books and records of its nonutility subsidiaries. In addition, during formal proceedings,

it may be necessary for the Commission to review the operations of the unregulated subsidiaries to effectively monitor the relationship between the RECC and its subsidiary.

Thus, the Commission shall have access to the books and records of the satellite-TV subsidiaries. Access to the books and records will be provided upon written request by the Commission. The request should state with particularity the specific issue of concern and the reason or reasons why access to the books and records is necessary. Any objection to such request shall be timely raised and the respondent will have the burden to show that the request is unreasonable. Confidential, proprietary, or otherwise privileged information related to nonutility activities will be afforded appropriate protection under applicable Commission procedures.

REPORTING REQUIREMENTS

In order for the Commission to effectively monitor the activities of the RECCs and the satellite-TV subsidiaries and to ensure ratepayer protection, certain additional reports shall be required of the RECCs.

Annual Reports

The Commission is aware that the REA has instructed its borrowers who have majority-ownership in a subsidiary to prepare consolidated financial statements in accordance with the requirements of the Financial Accounting Standards Board's Statement of Financial Accounting Standards ("SFAS") No. 94. These consolidated financial statements must also contain supplementary schedules presenting a balance sheet, income statement, and a

statement of cash flows for each majority-owned subsidiary. While SFAS No. 94 requires consolidation of majority-owned subsidiaries, REA has instructed its borrowers to prepare the REA Form 7 on an unconsolidated basis.

Under SFAS No. 94, majority-ownership is indicated when one company has a majority voting interest, either directly or indirectly, of over 50 percent of the outstanding voting shares of another company. Therefore, Salt River RECC will have to prepare consolidated financial statements due to its 100 percent ownership of Dish Wish TV. A copy of the consolidated financial statements should be submitted along with the annual report filed with the Commission. The RECCs that invested in KTI will not be required to prepare consolidated financial statements. However, this determination does not excuse those RECCs from accounting for the investment using the equity method. The RECCs investing in KTI should prepare their annual reports as usual, but these reports should be supplemented with financial schedules disclosing KTI activities which are included in the account balances shown on the balance sheet and income statement of the annual report. This requirement will also apply to those RECCs that, while not investors in KTI, provide satellite-TV to their members through KTI.

In addition, each RECC involved with satellite-TV should furnish the following information on an annual basis:

1. Copies of any and all contracts or agreements executed between the RECC and the satellite-TV company. After the initial filing of these documents, only reference to the document will be

required, as long as the terms have not been changed. Any change in a contract or agreement will require that a copy of the new document be filed, indicating the previous one it replaces.

2. A general description of the cost allocation methodologies the RECC has established and implemented to ensure the proper accounting of common or joint costs between the RECC and the satellite-TV company. After the initial filing of these descriptions, reference to the descriptions will be permitted, unless there have been revisions or additions. New cost allocation methodologies or revisions to existing methods should be disclosed in the year the change was made.

3. A copy of the RECCs' latest annual audit report, including any special reports on RECC internal controls.

General Rate Case Filings

As part of the RECCs' application in a general rate case, the RECC will provide updates on any contract or agreement relating to satellite-TV involvement in force during the test period. In addition, the RECC will provide explanations supporting the use of the particular cost allocation methodologies implemented to ensure the proper assignment of common joint costs. The explanations should include any documentation which supports the use of a particular allocation methodology.